Richard T. Ellis
Director – Federal Affairs

1300 I Street, NW
Suite 400 West
Washington, DC 20005
(202) 515-2534
(202) 336-7866 (fax)

July 18, 2002

Ex Parte

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th H Street, SW, Portals
Washington, DC 20554

Re: *Joint Application by Verizon for Authorization To Provide In-Region, InterLATA Services in States of Delaware and New Hampshire,* Docket No. 02-157

Dear Ms. Dortch:

On July 16, 2000 Verizon Executive Vice President and General Counsel William P. Barr sent a letter to FCC Chairman Michael Powell requesting further interpretation of and guidance regarding the application of TELRIC pricing methodology for unbundled elements. At the request of the FCC staff reviewing the above cited Joint Application, this letter is being entered into the record of this proceeding.

Please let me know if you have any questions. The twenty-page limit does not apply as set forth in DA 02-1497.

Sincerely,

Richard Ellis

cc: H. Thaggert
V Schlesinger
G. Remondino
T. Wilson

William P. Barr
Executive Vice President and General Counsel

Verizon Communications
1095 Avenue of the Americas
New York, NY 10036

Phone 212.395.1689
Fax 212.597.2587

July 16, 2002

Honorable Michael Powell
Chairman
Federal Communications Commission
445 12th Street, SW
Washington, DC 20544

Dear Chairman Powell:

I congratulate you on the Commission's victory in the Supreme Court in the TELRIC pricing cases. The Commission, its staff, and its lawyers demonstrated a great deal of dedication in defending its rules in the various stages of litigation, and you have every reason to be proud of their efforts.

The Court's decision establishes that the Commission had the authority under the 1996 Act to adopt TELRIC as the pricing methodology for unbundled elements. It does not, however, resolve either the numerous disputes about how the existing rules should be interpreted and applied, or whether those rules should be modified to ensure the appropriate incentives for efficient investment, entry, and other competitive decisions by all providers. As you are no doubt aware, parties routinely offer views as to the meaning of TELRIC in the course of section 252 arbitrations and section 271 proceedings that differ starkly from the views expressed by the Commission before the Supreme Court, and states themselves have adopted (and continue to adopt) interpretations that depart widely from those views as well.

Accordingly, the Commission should provide greater guidance as to how the existing rules can be applied in the most economically appropriate manner possible, and ultimately modify the rules to the extent necessary to ensure they send the right economic signals to all providers. It can do so through a number of proceedings: in its review of section 271 applications, in the *Triennial Review* rulemaking, where a number of parties have already raised pricing issues, and in any arbitration or other such proceeding that may come before the Commission.

With respect to the existing rules, the disputes typically center on five key issues that are central to an economically appropriate forward-looking pricing scheme. As previously explained by a number of prominent economists including Dr. Alfred Kahn and this Commission's former chief economist, Dr. Howard Shelanski, additional clarification with respect to each will help produce forward-looking cost-based prices that are more appropriate for use in today's marketplace.

First, the Commission should further clarify the appropriate calculation of the cost of capital. While the Court endorsed the use of the currently authorized 11.25% rate of return as a reasonable starting point, it agreed with this Commission's conclusion that this figure should be "adjusted upward" to the extent that the relevant risks warrant doing so. As the Commission explained to the Court, "an appropriate cost of capital determination takes into account not only existing competitive risks . . . but also risks associated with the regulatory regime to which a firm is subject." (FCC Reply Brief at 12 n.8.)

Both these types of risk require an upward adjustment to the 11.25% starting point. As the Fact Report filed on behalf of Verizon and others in the *Triennial Review* demonstrates, both today and going forward, incumbents face significantly greater competitive risks from both intramodal and intermodal competitors who have made substantial investments in their own facilities than when the Commission adopted the pricing rules. Moreover, the regulatory risks inherent in the competitive market assumptions embodied in TELRIC – such as the assumption that the network is replaced with the most efficient technology currently available – also require an upward adjustment to the cost of capital. Indeed, AT&T and WorldCom's own economic expert has conceded that "all the model assumptions have to be consistent. So, to the degree that it requires a competitive market to get all of the other assumptions, that would be true of the cost of capital as well."

Thus, because TELRIC requires that prices be set based on various competitive assumptions, the cost of capital calculated under TELRIC must reflect the risks associated with those assumptions. The Commission accordingly should make clear that an 11.25% cost of capital that was based on the risks an incumbent faced in the absence of competition must be adjusted upward to reflect the competitive and regulatory risks an incumbent faces providing unbundled elements priced at TELRIC. Indeed, the principal proponents of TELRIC use a materially higher cost of capital when it comes to making their own business decisions. At a minimum, a reasonable application of TELRIC principles should incorporate a cost of capital no lower than that employed by these competing providers themselves.

Likewise, a reasonable application of the existing rules must include an appropriate factor to take into account the uncollectibles that will be experienced by the carriers providing unbundled elements. As with any start-up enterprises, it is to be expected that a portion of the charges incurred by carriers utilizing unbundled elements will become uncollectible. Experience to date has borne out this expectation, with uncollectible levels substantially higher than those historically incurred for other customers. If this fact is not reflected in the underlying prices, the carrier providing the unbundled element is left holding the bag. Accordingly, a reasonable forward-looking pricing standard must fully account for the expected level of these uncollectibles, and, in doing so, must take into account ongoing developments in the marketplace.

Second, the Commission should further clarify the appropriate treatment of depreciation. Here again, the Court agreed with the Commission that TELRIC permits variations from regulatorily prescribed depreciation lives, particularly when those prescriptions are demonstrably out of date. At an absolute minimum, the Commission should make clear that the starting point should be the same lives that are used for financial reporting purposes in accordance with well-recognized accounting principles. The Commission itself has previously approved the use of financial reporting lives in connection with section 271 applications by Verizon in Pennsylvania and Southwestern Bell in Oklahoma. Such lives are intrinsically forward-looking and are updated frequently to reflect technological and other changes that affect the length of an asset's economic life. By contrast, regulatorily prescribed lives are often not nearly as current – some parties have advocated the use of regulatory lives set as long ago as *1994*, even before the Act was passed – and are not appropriate for use even as a starting point in the marketplace of today and tomorrow.

Third, even in a TELRIC study, the assumed technology mix cannot be inconsistent with the limits of such technology. As an initial matter, although the Commission's rules and now the Court have expressly found that TELRIC requires only the use of *currently available* technologies, CLECs, and some states, have continued to base costs on theoretical or allegedly foreseeable technologies. The clearest example of this fallacy is the assumed use of the GR-303 interface in connection with digital loop carrier technology. It is neither rational nor cost-minimizing to deploy GR-303 over the long run given rapidly changing technology. Moreover, as the Commission itself recently found in connection with BellSouth's 271 application for Georgia, unbundling standalone loops using integrated digital loop carrier technology with GR-303 simply is "not practicable." Although some parties claim that such unbundling is *theoretically possible* (though not currently available), that is not the standard.

More generally, the Commission should clarify that, even for a replacement-cost model such as TELRIC, while it may require a firm to consider the *possibility* that all inputs (except wire center locations) may be varied, it does not require a firm to assume that all of its current inputs are *instantaneously* replaced with what appears to be the best or least cost technology today, or to assume false economies that supposedly would result from such an instaneous replacement. The Commission already has recognized this point in its decisions concerning the appropriate mix of switching technologies. Although an instantaneous, one-time replacement model presumably would result in only new switches perfectly sized to meet current and expected future demand, the Commission has made clear in both its Rhode Island and Georgia/Louisiana 271 orders that it is perfectly appropriate to assume a mix of new switches and growth additions and other incremental upgrades.

Nor can an extreme instantaneous and ubiquitous replacement approach be justified on the theory that the value of existing assets and therefore costs are immediately driven down to the value of the current least-cost technologies. While the costs of new technologies may have a constraining effect on the value of existing facilities, the scope of that effect depends on a complex interaction of different variables and in many cases will not actually lower the cost of providing service with the existing asset. To take one simple example, if Boeing were to develop a new, more efficient commercial aircraft, no airline would instantaneously replace all the planes in its fleet with this new type of aircraft. Moreover, the ticket prices for airline seats would not be instantaneously reduced to reflect the lower operating costs of the new type of plane. This latter point is critical because the market at issue in UNE proceedings is not the sale of the underlying asset (such as the plane), but *services* provided over that asset (a ride between two cities). Thus, even if the development of a new switch would constrain the resale value of an older switch in the secondary market, it does not follow that the rate for leasing capacity on the older switch would instantaneously be reduced to the cost of leasing capacity on a hypothetical network having all new switches.

Fourth, the Commission should recognize that existing fill factors in incumbent networks, which reflect the amount of spare capacity available to account for administrative needs, demand fluctuations and churn, breakage, and growth, represent a reasonable estimate for purposes of a TELRIC study. Verizon has clear incentives, due to both competitive pressures and price-cap regulation, to reduce the amount of such spare as much as possible so as to lower its costs. At the same time, there must be sufficient spare to meet relevant service quality requirements so that, for example, Verizon can provision second lines or meet spikes in demand in a particular location within the time period required by a state commission.

For example, the fill factors observed in Verizon's network are the by-product of its efforts to design and engineer a network that best balances the relevant considerations. These factors have remained remarkably stable, notwithstanding changes in technology and demand, and there is no reason to believe that they will or should increase in a forward-looking network. On the contrary, there is strong reason to believe that fill factors are at least as likely to decline as to increase. Traffic increasingly is being diverted to the networks of intermodal competitors such as wireless and cable companies. In fact, as the Commission's own ARMIS data shows, traffic volumes already have decreased in many instances. As a result, while a TELRIC network built today would have to include sufficient capacity to handle both current volumes and any growth or spikes in demand that may occur in particular locations, the average fill factor going forward is as likely to be lower as it is to be higher.

Fifth, the Commission should continue to make clear that carriers are entitled to recover the non-recurring costs they incur to make unbundled elements available. While the Commission previously held precisely that, some parties continue to claim (with varying degrees of success) that these costs should be ignored, typically on the theory that the tasks would be costless in some purely hypothetical future network. But the Commission has rejected this very claim in the context of loop conditioning charges where some of the same parties argued that conditioning would not be required in an ideal future network. As it has in the past, the Commission should continue to make clear that these very real costs must be recovered from the carriers on whose behalf they are incurred.

In addition to clarifying how the existing rules should be interpreted and applied so as to be as economically appropriate as possible, the Commission also should consider modifications to those rules to make them appropriate for use in today's competitive marketplace. In particular, the Commission should alter its methodology to eliminate the assumption that the existing network is completely "reconstructed" to reflect a technology mix that goes beyond what likely will ever be in place in any real-world network.

A more economically correct approach would look to what the network is expected to look like during a reasonable, forward-looking planning period over which it is possible to predict what technologies will be deployed in the network. In a market with rapidly changing technologies, such a period may be in the range of three to five years, which, as the Court observed, also is the typical length of interconnection agreements. Because the network that will be in place during such a planning period represents the forward-looking network the incumbent will use to provide unbundled elements, the cost of that network is the most economically correct measure of forward-looking costs.

As Drs. Kahn and Shelanski have explained, it also is the economically appropriate target for competing providers to shoot at as they make investment decisions of their own. If they are able to deploy more efficient technologies than the incumbent has in place, or deploy them in a more efficient manner, then they should do so. This, in turn, will prompt the incumbents to invest in efficiency-enhancing measures of their own, and so on as the cycle continues. This is the essence of what economist Joseph Schumpeter termed the process of "creative destruction" that is central to the workings of a market economy. And it is critical to instilling all competing providers with the incentive to make economically rational investments in the telecommunications sector.

In sum, this letter touches on a few key issues that have arisen concerning how TELRIC is to be interpreted and concretely applied in setting rates and whether it should be modified to better estimate forward-looking costs. These same disputes have been, and continue to be, echoed in section 252 arbitrations and 271 proceedings across the country. The Commission can and should use proceedings before it to resolve some of these fundamental pricing issues. Doing so will provide much-needed additional certainty and reduce the burden that these proceedings place on the resources of carriers and state commissions alike. More fundamentally, Commission resolution of these issues can help ensure that TELRIC is interpreted in the most economically appropriate manner so that UNE prices provide the best possible market signals to ILECs, CLECs and intermodal competitors alike, a result that is critical to the continued investment by all competing providers.

Sincerely,

WP Barr (by [illegible])

William P. Barr

Cc: Commissioner Abernathy
Commissioner Copps
Commissioner Martin